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In The
SUPREME COURT OF THE UNITED STATES

October Term, 1942

No. **724**

CENTRAL WEST COAL COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**Petition for Writ of Certiorari to the
United States Circuit Court of Appeals for the
Seventh Circuit and Brief in Support thereof.**

**IRVING A. PUCHNER,
STANLEY E. EASTMAN,
B. F. SALTZSTEIN,
Counsel for Petitioner.**



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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari.

*To the Chief Justice of the United States and Associate
Justices of the Supreme Court of the United States—*

May It Please the Court:

The Petition of the Central West Coal Company respectfully shows to this Honorable Court:

A.

STATEMENT OF MATTER INVOLVED.

The Commissioner of Internal Revenue on November 22, 1939 served notice on the Petitioner, Central West Coal

Company, of an additional assessment of income taxes for the years 1937 and 1938 upon undistributed income. Subsequently, claims for refunds for the same year for income taxes paid on undistributed income were filed by the Petitioner. The claims for refunds were based on the same facts and law upon which Petitioner claimed the right to have the deficiency assessments set aside. The taxes involved total \$18,291.44.

The United States Board of Tax Appeals approved of the determination of deficiencies by the Commissioner and denied any refunds. The Circuit Court of Appeals for the Seventh Circuit approved the decision of the Board of Tax Appeals.

STATUTE INVOLVED.

The statute involved is Section 26 (c) (1) of the Revenue Act of 1936. It provides as follows:

“In the case of a corporation, the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * *

(c) Contracts Restricting Payment of Dividends.

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.”

The questions raised under the foregoing statute were whether, by reason of provisions contained in the Articles of Incorporation of the Petitioner setting out the rights and

privileges of the preferred stock and in the trust mortgage respecting dividends, the Petitioner was prohibited by a written contract from paying dividends on its common stock.

The Petitioner, Central West Coal Company, is engaged in the wholesale and retail coal business. Its capital structure consists of common stock, preferred stock, and first mortgage bonds.

RESTRICTIONS IN ARTICLES OF INCORPORATION AND TRUST DEED ON PAYMENT OF DIVIDENDS ON COMMON STOCK.

In April of 1921, the Articles of Incorporation of the Petitioner were amended to provide for the issuance of \$100,000 of preferred stock (R. 60). The terms upon which the preferred stock was issued so far as they are material to this case are as follows (R. 49):

“

* * *

“The capital stock of the corporation hereby organized is the sum of Two Hundred and Fifty Thousand Dollars, of which One Hundred and Fifty Thousand Dollars shall be common stock, and One Hundred Thousand Dollars shall be preferred stock.

“The holders of such preferred stock shall be entitled to receive, in preference to all other stock of the company now or hereafter authorized, but only when and as declared by the board of directors, and only from the surplus or net profits of the company when and as determined by the board of directors, dividends at the rate of, but not exceeding, seven per centum per annum from the date of the issue of the stock, payable semi-annually, upon such dates as the board of directors may from time to time determine. *Such dividends shall be cumulative, so that if at any time all dividends on the preferred stock at the rate of seven per centum per annum up*

to such time shall not have been declared and paid or a sum sufficient for the payment thereof set apart and appropriated to such payment, the deficiency shall be paid or a sum sufficient for the payment thereof set apart and appropriated to such payment before any dividend shall be declared or paid upon or set apart for any other stock of the company. Whenever from time to time all cumulative dividends upon the preferred stock for each previous year and such dividends then accrued for the current year shall have been declared and paid, or a sum sufficient for the payment thereof shall have been set apart and appropriated to such payment, the board of directors may in its discretion declare dividends upon the common or other stock of the company payable out of the then remaining surplus or net profits, and may fix and change the dates for the declaration and payment of such dividends (Italics ours).

* * *

"All of such preferred stock shall be subject to redemption at par on the 1st day of June, A. D. 1936, but the corporation may, however, at any dividend payment period redeem all or any portion of its preferred stock at par with the accrued dividends thereon by giving thirty days' notice of its intention to redeem any stock selected for redemption, by mailing the same to the stockholder at his post office address as shown upon the books of the company. From and after the date of redemption as shown in such notice (unless default be made by the company in the payment of the redemption price pursuant to such notice) all dividends upon such stock shall cease to accrue and all rights of the holders of such stock as stockholders of the company, except the right to receive the redemption price, shall cease and determine."

The last dividend paid on the preferred stock was during the fiscal year May 1, 1932 to April 30, 1933 (R. 29).

On the 25th day of July, 1928, the Petitioner executed a trust deed to secure the payment of \$400,000 par value of bonds maturing serially. On August 1, 1931, \$40,000,

and each year thereafter \$30,000 of bonds became due (R. 59).

The terms of the trust indenture insofar as they are material to the issues in this case are as follows (R. 49):

“

* * *

The Mortgagor covenants that it will not pay any dividend on its common capital stock during the first three years succeeding the date of this indenture, if its earnings together with the earnings of its acquired property for the twelve months immediately preceding shall, after the payment of taxes and depreciation, but before the payment of the interest charges on the bonds issued hereunder, be less than Sixty Thousand Dollars.

“The Mortgagor further covenants that after the expiration of three years from the date hereof it will not pay any dividend upon its common capital stock until the principal of said bonds then maturing and interest on all outstanding bonds, together with service charges, shall have been provided for. Dividends declared within ninety days after the close of the Mortgagor's fiscal year out of the net earnings of such year shall be considered as dividends declared during such fiscal year for the purposes of this section.

“In the event of any misunderstanding or dispute over the proper construction or interpretation of this section and/or its proper application to a given transaction contemplated by the Mortgagor, the determination by a disinterested accountant of recognized good standing selected by the Trustee, shall be final and conclusive upon the parties, and the failure or refusal of the Mortgagor to abide by and follow such determination shall *ipso facto* constitute a default under this mortgage. The expenses of procuring such determination by such public accountant, as aforesaid, shall be borne by the Mortgagor.”

The parties to the trust deed construed the words “provided for” in the restrictive clause to mean “earned” and

the undisputed evidence was that such was the accepted meaning in the investment business.

EARNINGS OF PETITIONER.

Though the Petitioner retired \$40,000 of its bonds on August 1, 1931, and \$30,000 annually thereafter (R. 28), earnings were insufficient to provide funds for that purpose. Maturities were first met out of profits, but when they were exhausted, depreciation reserves, working capital and funds realized from the sale of assets were resorted to (R. 27).

The fiscal year of the Petitioner commences on May 1st and ends the April 30th next following. During the period May 1, 1930 to April 30, 1938, the end of the last tax year in question, the Petitioner paid \$250,000 in bonds that matured. During the same period net profits from its business were \$2,616.55. During the period May 1, 1930 to April 30, 1937, the end of the first tax year in question, Petitioner paid \$220,000 in bonds and suffered a net loss of \$31,879.65 (R. 24-5).

At the beginning of the period May 1, 1930 to April 30, 1938, the Petitioner had an earned surplus of \$167,149.95 (R. 53). Charging against the sum the amounts paid for dividends, interest, retirements of bonds, and retirement of preferred stock, a deficit to earned surplus of \$141,534.50 existed at the end of the period (R. 57). If only bond maturities and interest are charged to earned surplus, the deficit is \$91,189.75.

If the period commencing May 1, 1930 is ended April 30, 1937, the end of the first tax year, the deficit to earned surplus, if redemption of preferred stock and accrued dividends thereon, as well as interest and bond maturities, are charged to earned surplus, is \$159,530.70 (R. 57). If only

bond maturities and interest paid are charged to earned surplus, the deficit is \$93,977.95.

The fiscal year ended April 30, 1931, was the last year in which dividends were paid on the common stock. The dividends were paid out of profits of the previous twelve months (R. 28).

B.

JURISDICTION OF THIS COURT.

The decision of the United States Circuit Court of Appeals for the Seventh Circuit was filed November 11, 1942. This petition was filed within three months after that date. This court has jurisdiction to review the decision of the Circuit Court of Appeals for the Seventh Circuit by virtue of Section 240 of the Judicial Code, as amended, (28 U. S. C. A. 347, 350) and Rule 38 of the Rules of the Supreme Court.

C.

QUESTIONS PRESENTED.

The questions presented are:

1. Are the Articles of Incorporation and the provisions thereof set out in the preferred stock certificate prohibiting payment of dividends on the common stock until dividends on the preferred stock with all arrearages have been paid, a written contract within the meaning of Section 26 (c) (1)?

2. The parties to the trust mortgage construed it to mean that the Petitioner was prohibited from paying dividends on its common stock until the principal of the bonds then maturing and interest and charges had been paid out of earnings. Is that construction, adopted by the parties, the best evidence as to the meaning of the contract?

D.

REASON RELIED ON FOR THE ALLOWANCE
OF THE WRIT.

1. The decision of the Circuit Court of Appeals for the Seventh Circuit in this case is in conflict with the decision of the Circuit Court of Appeals for the Third Circuit.

Lehigh Structural Steel Co. vs. Comm. (C. C. A. 31), 127 F. (2d) 67.

In that case it was held that a provision in a preferred stock certificate restricting payment of dividends was a contract within the meaning of Section 26 (c) (1).

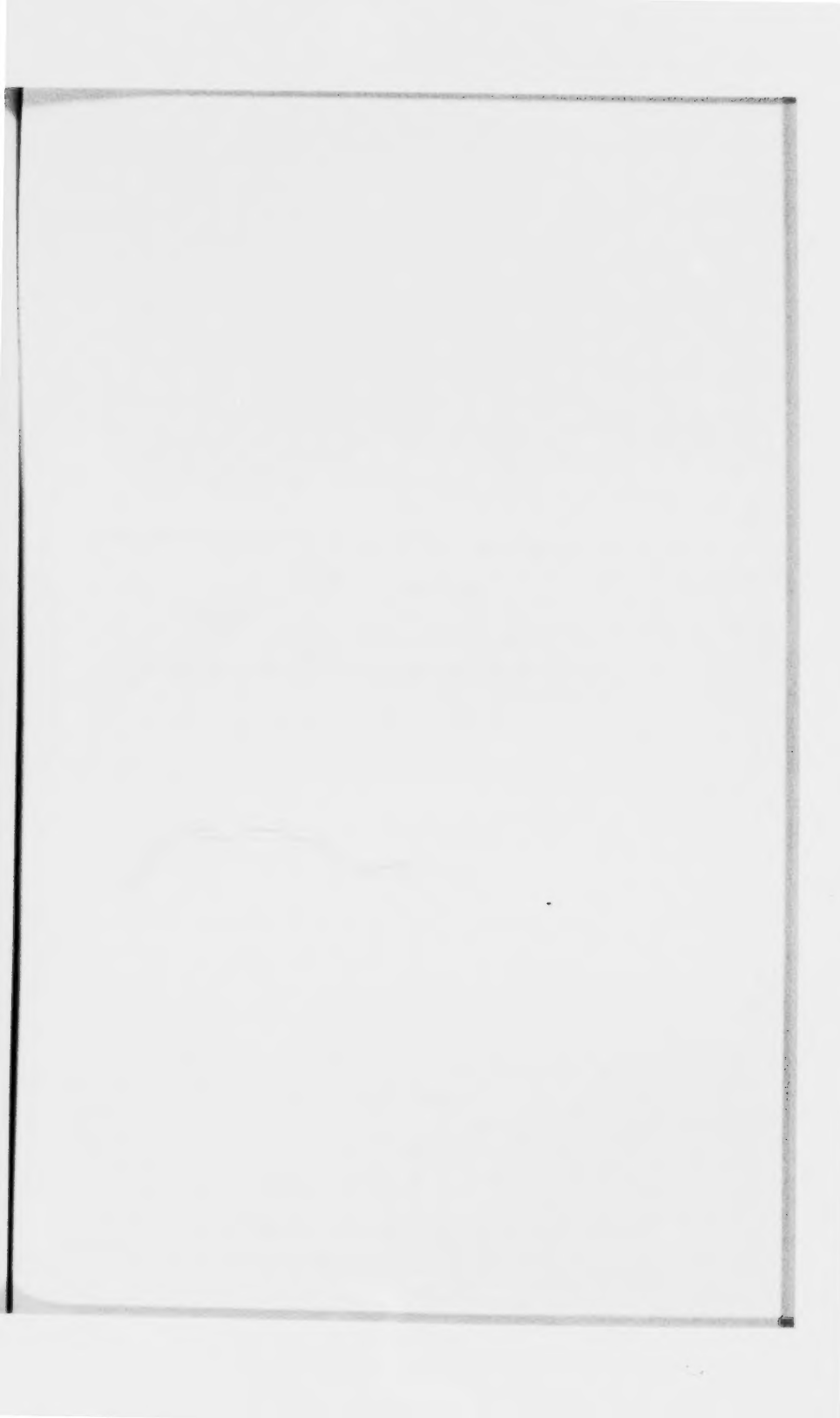
2. The decision of the Circuit Court of Appeals for the Seventh Circuit is in conflict with the applicable decision of this court and general law. Those decisions hold that the construction placed upon a contract by the parties is the best evidence as to its meaning.

Chicago vs. Sheldon, 75 U. S. (9 Wall 50, 54; 19 L. Ed. 594);

Page on the Law of Contracts, Section 2034, 1919-1920 Supplement and Second Edition.

Wherefore, Petitioner respectfully prays that a writ of certiorari issue under the seal of this court to review the decree of the Circuit Court of Appeals for the Seventh Circuit in the above case, and that said decree be reversed.

IRVING A. PUCHNER,
STANLEY E. EASTMAN,
B. F. SALTZSTEIN,
Counsel for Petitioner.





In The
SUPREME COURT OF THE UNITED STATES

October Term, 1942

No.

CENTRAL WEST COAL COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**Brief in Support of Petition for
Writ of Certiorari.**

I.

OPINION OF THE COURT BELOW.

The opinion of the Circuit Court of Appeals for the Seventh Circuit is not as yet reported.

II.

JURISDICTION.

The decision of the Circuit Court of Appeals sought to be reviewed was entered November 11, 1942. The jurisdic-

tion of this court is invoked under Section 240 of the Judicial Code, as amended (28 U. S. C. A. 347, 350) and Rule 38 of the Rules of the Supreme Court.

III.

STATEMENT OF FACTS.

The facts have been sufficiently stated under the heading "A" in the Petition.

IV.

ASSIGNMENT OF ERRORS.

The Circuit Court of Appeals erred:

1. In holding that the provisions of the Articles of Incorporation set out in the preferred stock certificates prohibiting payment of dividends on the common stock until dividends on the preferred and cumulations had been paid, do not constitute a contract within the meaning of Section 26 (c) (1) of the Revenue Act of 1936.

2. In not adopting the construction placed upon the disputed trust deed provisions adopted by the parties, i.e., no dividends could be paid on the common stock until the principal then maturing and interest and charges had been paid by Petitioner out of earnings.

V.

A R G U M E N T .

A.

Failure to pay dividends upon preferred stock made operative restrictive covenant of preferred stock issue prohibiting payments on common stock when cumulative dividends on preferred were in arrears.

The last dividend paid on the preferred stock was during the fiscal year May 1, 1932 to April 30, 1933 (R. 31). On June 1, 1936 the preferred stock became payable (R. 50). By the terms of the restrictive covenant contained in the amendment to the Articles of Incorporation authorizing the issuance of the preferred stock (set out in the petition) no dividends could be paid on the common stock until all cumulative dividends on the preferred had been paid or a sum sufficient for the payment thereof set aside and appropriated to such payment (R. 49). It is undisputed that the Petitioner has paid a large portion of its bond indebtedness out of assets other than those represented by profits and earned surplus. It has used working capital and depreciation reserves.

The last dividend on the preferred stock was paid on October 15, 1932 (R. 31). Exhibit 6 shows that thereafter they were accrued (R. 55-7). Inasmuch as the dividends on the preferred stock had accumulated since 1933, no dividends could have been paid on the common stock during the tax years in question.

The facts of this case are unlike *Helvering vs. Northwest Steel Rolling Mills, Inc.*, 61 S. Ct. 109. In that case the restriction was created by statute. In this case the restriction is provided for in express language in the Articles of Incorporation and in the certificates. Statutory prohibitions against payment of dividends are subject to

modification by the State. Provisions in Articles of Incorporation determining the rights between classes of stockholders constitutes a contract between such stockholders and the corporation.

Lehigh Structural Steel Co. vs. Commissioner (C. C. A. 31), 127 F. (2d) 67;

Allen vs. Francisco Sugar Co., 110 A. 37, 38;

Dow vs. Northern Railroad, 36 A. 510, 512;

Allen vs. White, 103 Nebr. 256, 171 N. W. 52;

Johnson vs. Bradley Knitting Co., 228 Wis. 566, 580, 584, 280 N. W. 688.

B.

Construction placed on contract by parties is the best evidence of its meaning.

The restriction in the trust deed is set out in the Petition under the heading "Statement of Matters Involved."

The Petitioner contends the restrictive clause prohibits payments of dividends upon the common stock until all bond maturities and interest have been provided for out of earnings and that inasmuch as since the date of the bond issue payments of principal and interest were in excess of earnings plus the earned surplus existing at the date of the bond issue, the Petitioner was prohibited from paying dividends on its common stock during the tax years in question.

The construction to be given the restrictive clause depends upon the meaning of the phrase "provided for". When the restrictive covenant is read, the question naturally arises "Provided for how?", or "Provided for in what way?"

The Tax Board construed the words "provided for" to mean paid. The Petitioner construes the words "provided for" to mean *earn*, or *provide for out of earnings*. Obvi-

ously the words "provided for" literally construed do not mean paid and just as obviously do not mean earned.

Likewise, if we use a synonym for provide, such as procure, we run into the same difficulty; procure how?—by earning? by borrowing?

It seems obvious that the court must in some way try to find out what the parties to the trust deed meant when they used the phrase "provided for".

The parties to the trust deed construed the words "provided for" in the restrictive clause to mean "earned". Henry Marin, trustee of the bond issue, testified that he had several conversations with Mr. Smith, president of the Petitioner, about the construction to be given the restrictive clause (R. 38). In 1936 they both agreed that "there wasn't going to be any prospect of any dividends being paid on the common stock because earnings weren't sufficient to take care of it * * *" (R. 39).

Henry Marin, trustee, testified further as follows: (R. 39-40)

"Q. Will you state what your understanding was with Mr. Smith, as to whether the Central West Coal Company would pay dividends?

* * *

"A. My understanding was they couldn't pay dividends.

"Q. Why?

"A. Because they didn't have any surplus out of which to pay those dividends."

If payments of interest and principal of the bond issue were charged against "earned surplus", no surplus existed, as Mr. Marin testified, out of which dividends could be paid. If, however, they had not construed the trust indenture to mean that no dividends could be paid unless interest and principal had been "provided for" out of earnings, a surplus would have existed out of which dividends could have been declared.

The fact is undisputed that from 1931 to 1938 no dividends were paid upon the common stock. Therefore, the construction of the restrictive covenant adopted by the parties to the contract was in fact carried out. The rule of law is well established that the construction placed upon a contract of the parties is the best evidence as to its meaning.

Section 2034, *Page on the Law of Contracts*, 1919-1920 Supplement and Second Edition;
 13 C. J. 546, Par. 517, Contracts;
Leavitt vs. Windsor Land & Investment Co., 54 Fed. 439;
Chicago vs. Sheldon, 75 U. S. (9 Wall) 50, 54; 19 L. Ed. 594.

The trust deed also provides that if the parties to the indenture are unable to agree as to the meaning of the restrictive covenant, the determination by a disinterested accountant of good standing shall be conclusive.

The trustee and Petitioner agreed from the beginning that the restrictive covenant in the trust deed prohibited any payment of dividends until all bond maturities and interest had been paid out of earnings. Now, if they had disagreed, and the accountant to whom the dispute was referred had determined that dividends could not be paid on the common stock unless the bond maturities and interest had been met out of earnings, it must be conceded there would be no question as to the meaning of the restrictive covenant. Can it be said that the agreement of the parties, thereby saving reference to an accountant, has any less binding effect?

At the time the trust deed was executed in 1928, the tax law in question was not in existence. The parties to the contract obviously had in mind the protection of bondholders. It was desired that the assets of the corporation

be not dissipated in dividends to the prejudice of bondholders. The trustee testified (R. 38):

"At the time the bond issue was arranged for, the bank of which I was cashier was interested in buying bonds for disposal to our customers, and I was also co-trustee under the terms of the bond issue, so that I had an interest in that way as well, and talking with Mr. Smith I was particularly interested to know just how these funds were going to be handled, because after all we were selling or we did sell to customers \$100,000 worth of these bonds, and that was one-fourth of the issue, and naturally we wanted to know there wasn't going to be any dividends, there weren't going to be any dividends paid which would tend to impair the security back of these bonds or make it difficult to pay those bonds as they matured beginning, I believe, in about 1931."

The \$400,000 of bonds issued by Petitioner matured in series—\$40,000 in 1931 and \$30,000 annually thereafter. What good purpose could possibly be served by a restrictive covenant which would permit Petitioner, by paying a single year's maturity, to declare a dividend up to the amount of earned surplus? Bondholders would have no protection so far as depleting the assets of the corporation is concerned.

What the parties undoubtedly had in mind was that the assets existing at the time of the execution of the trust deed were to remain as security for the payment of the bonds. Dividends could only be paid after bond maturities and interest had been provided for out of earnings. Unless that interpretation is given, the restrictive covenant serves no useful purpose. As between two possible constructions, the one more fair and reasonable should be adopted.

Par. 2053, *Page on the Law of Contracts* (2d Ed. 1920).

The Circuit Court of Appeals rejected the construction adopted by the parties because of the finding by the Tax Board "that the parties had never looked to earnings for payment, but that annual payments had been made out of working capital, reserves and proceeds from the sale of assets as well as earnings."

The testimony is undisputed that bond maturities were paid first through profits and after those were exhausted through moneys from working capital, sale of assets and depreciation reserve (R. 27).

Certainly because earnings were insufficient to pay bond maturities, and other funds had to be used, it does not follow that the parties did not intend that bond maturities were to be paid out of earnings before dividends could be paid on the common stock.

Wherefore, Petitioner prays that certiorari to the Circuit Court of Appeals for the Seventh Circuit be granted and the decision of that court in this case be reversed.

Respectfully submitted,

IRVING A. PUCHNER,
STANLEY E. EASTMAN,
B. F. SALTZSTEIN,
Counsel for Petitioner.





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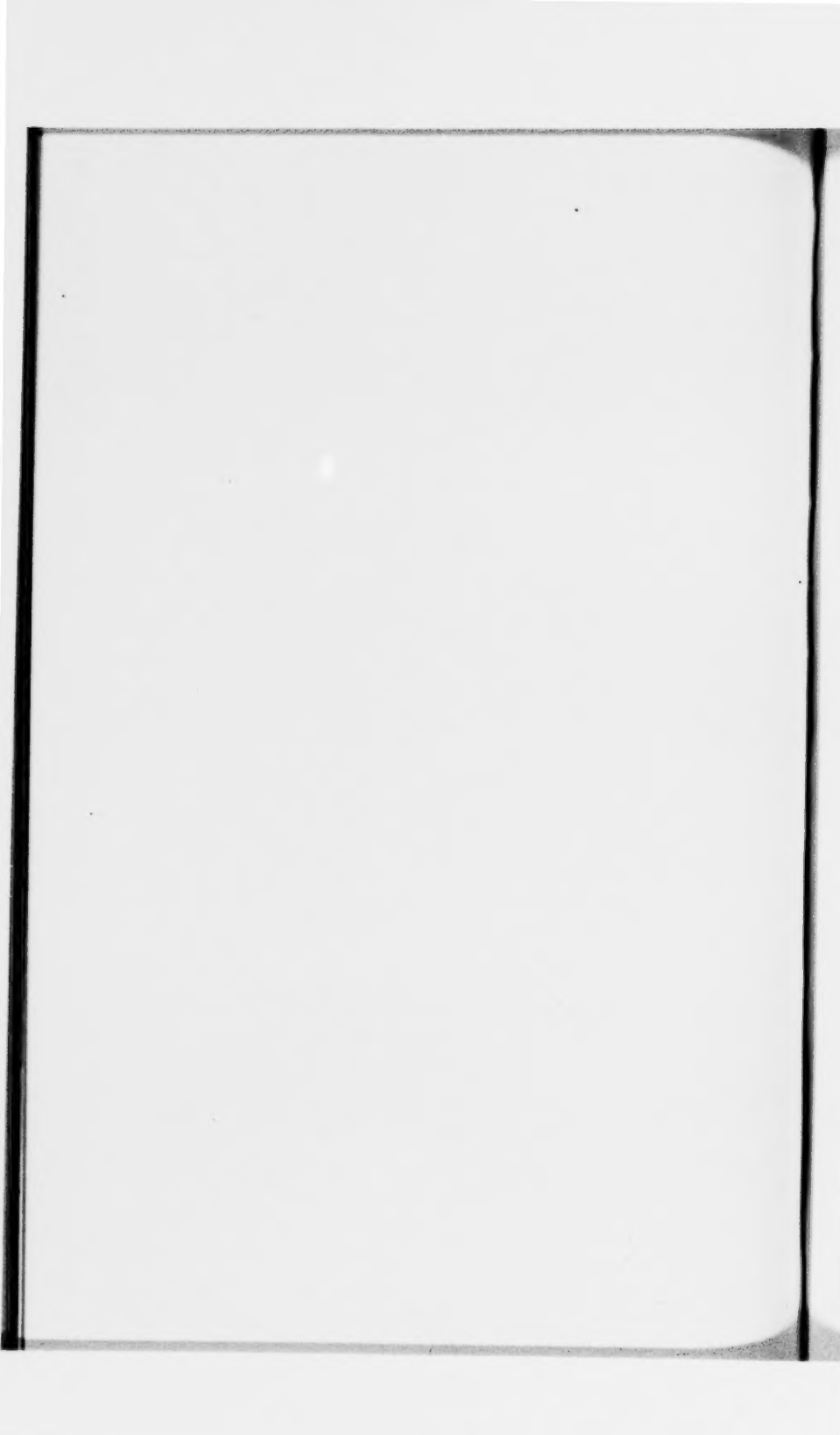
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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 724

CENTRAL WEST COAL COMPANY, A CORPORATION,
PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL
REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH
CIRCUIT*

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 58-69) is reported at 44 B. T. A. 661. The opinion of the Circuit Court of Appeals (R. 83-86) is reported in 132 F. 2d 190.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered November 11, 1942 (R. 87). The petition for a writ of certiorari was filed February 11, 1943. The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, in determining the taxpayer's liability for surtax on undistributed profits under Section 14 of the Revenue Act of 1936, the taxpayer was entitled, in arriving at its "undistributed net income," to any credit under Section 26 (c) (1) of that Act by reason of either the provisions of a deed of trust securing its bonds or the provisions of its preferred stock relative to the payment of dividends.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 12-18.

STATEMENT

The Board of Tax Appeals found the following facts (R. 59-62):

The taxpayer is a Michigan corporation, engaged in the coal business. During the taxable years (fiscal years ended April 30, 1937, and April 30, 1938), the taxpayer had outstanding first mortgage bonds, preferred stock, and common stock (R. 59).

The bonds were issued on August 1, 1928, in the total amount of \$400,000 par value. They were first mortgage bonds secured by a deed of trust executed by the taxpayer on July 25, 1928,

and bore interest at the rate of 6 percent per annum, payable semiannually, on the first day of August and February in each year. They were to mature serially, beginning with \$40,000 on August 1, 1931, and then \$30,000 on August 1 of each year thereafter until August 1, 1943; they were subject to redemption prior to maturity upon payment of a premium of 2 percent. The deed provided in part as follows (R. 59-60):

The Mortgagor further covenants that after the expiration of three years from the date hereof it will not pay any dividend upon its common capital stock until the principal of said bonds then maturing and interest on all outstanding bonds, together with service charges, shall have been provided for. Dividends declared within ninety days after the close of the Mortgagor's fiscal year out of the net earnings of such year shall be considered as dividends declared during such fiscal year for the purposes of this section.

In the event of any misunderstanding or dispute over the proper construction or interpretation of this section and/or its proper application to a given transaction contemplated by the Mortgagor, the determination by a disinterested accountant of recognized good standing selected by the Trustee, shall be final and conclusive upon the parties, and the failure or refusal of the Mortgagor to abide by and follow such determination shall *ipso facto* constitute a default under this mortgage. * * *

The preferred stock was authorized in the amount of \$100,000 par value by resolution of the taxpayer's stockholders on April 13, 1921. By the terms of the resolution, and of the stock certificates issued thereunder, this stock was to be redeemed at par on June 1, 1936, with the option on the part of the taxpayer before that date to redeem all or any part thereof at par plus accrued dividends. The resolution and the certificates provided (R. 60):

The holders * * * shall be entitled to receive in preference to all other stock * * *, but only when and as declared by the board of directors, and only from the surplus or net profits * * * when and as determined by the board of directors, dividends at the rate of * * * seven per centum per annum * * * payable semi-annually * * *. Such dividends shall be cumulative, so that if at any time all dividends on the preferred stock at the rate of seven per centum per annum up to such time shall not have been declared and paid or a sum sufficient for the payment thereof set apart and appropriated to such payment, the deficiency shall be paid or a sum sufficient for the payment thereof set apart and appropriated to such payment before any dividend shall be declared or paid upon or set apart for any other stock * * *. Whenever * * * all cumulative dividends upon the preferred stock for each previous year and

such dividends then accrued for the current year shall have been declared and paid, or a sum sufficient for the payment thereof shall have been set apart and appropriated to such payment, the board of directors may * * * declare dividends upon the common or other stock * * * payable out of the then remaining surplus or net profits, * * *.

The taxpayer paid interest on and retired the bonds as they matured in accordance with the terms of the deed of trust, including all maturities in the taxable years. It paid principal of the bonds in amounts totaling \$220,000 from August 1, 1931, to April 30, 1937, and \$250,000 from August 1, 1931, to April 30, 1938. The payments were made from earnings and other funds, such as working capital, reserves, and proceeds derived from the sale of physical assets—the evidence failing to disclose, however, what amounts were paid from any of the several sources mentioned. (R. 60-61.)

The amount of the taxpayer's preferred stock issued and outstanding on April 13, 1933, was \$98,600 par value. Between that date and April 15, 1938, the taxpayer retired a substantial part of that preferred stock. The amount, in par value, of the preferred stock outstanding on April 30, 1936, was \$59,650, while on April 30, 1937, it was \$49,850, and on April 15 and April 30, 1938, it was \$36 350. (R. 61.) On April 15, 1937,

there remained accrued and unpaid, on the preferred stock, dividends in the amount of \$15,702.75, and on April 15, 1938, the accrued and unpaid dividends on that stock amounted to \$13,994.75 (R. 61).

The taxpayer's earned surplus as of April 30, 1930, was \$167,149.95. The earnings and the earned surplus as of the close of the fiscal years ended April 30, 1931, to April 30, 1938, as reflected by the books, are as follows (R. 61):

| Year (ended April 30) | Earnings | | Earned surplus |
|-----------------------|-------------|-------------|----------------|
| | Profit | Loss | |
| 1931 | | \$16,701.29 | \$135,948.66 |
| 1932 | | 45,479.96 | 82,468.70 |
| 1933 | | 8,155.63 | 70,802.67 |
| 1934 | | 23,389.08 | 47,412.99 |
| 1935 | \$21,034.66 | | 71,507.65 |
| 1936 | 26,295.24 | | 97,802.89 |
| 1937 | 28,219.16 | | 126,022.05 |
| 1938 | 32,788.20 | | 158,810.25 |

The balance sheets filed with the taxpayer's returns for the two taxable years ending in 1937 and 1938 disclose earned surplus in the respective amounts of \$126,022.05 and \$158,810.25 as of the close of the taxable years. They further show that the taxpayer had cash on hand in the amount of \$96,580.85 at the beginning of the taxable year 1937, in the amount of \$165,558.42 at the end of that year, and in the amount of \$96,454.38 at the end of the taxable year 1938. (R. 61.)

The profits and losses shown in the above tabulation represent the profits and losses computed

after adding to the net income of each year items of nontaxable income and deducting therefrom items such as life insurance premiums, Federal income taxes, dividends paid, losses, and other items not deductible in computing net income. They do not include any deduction or adjustment on account of the principal payments on bonds or preferred stock retired nor do they include any deduction on account of accrued and unpaid dividends on the preferred stock. (R. 62.)

In its returns, the taxpayer reported adjusted net income of \$45,562.55 for 1937 and \$43,514.55 for 1938. For each of the two taxable years the taxpayer claimed a credit of \$30,000 against the adjusted net income, on account of a contract (the deed of trust) restricting dividend payments, and (further claiming a specific credit of \$443.74 for 1937) the taxpayer reported undistributed net income subject to surtax in the amounts of \$15,118.81 and \$13,514.55 for the two years, and surtax due thereon in the amounts of \$1,917.82 and \$1,579.90, respectively. (R. 62.)

In his determination (R. 11-16), the Commissioner determined the adjusted net income of the taxpayer to be \$46,079.36 for 1937 and \$43,618.25 for 1938. Then, in arriving at the undistributed net income subject to the surtax, he disallowed the credits of \$30,000 claimed by the taxpayer in each year (R. 12-13, 15, 16, 62).

In the appeal to the Board of Tax Appeals, the taxpayer attacked the deficiencies asserted

against it, alleging error in the disallowance of the \$30,000 credit claimed in each of the two taxable years, and, after amending its petition, claimed further that it had made overpayments of surtax in the amounts (\$1,917.82 and \$1,579.90) shown to be due on the returns for those years because it was entitled to other credits, not claimed in the returns, on account of the preferred stock restriction against payment of dividends on its common stock (R. 58-59, 62).

The Board sustained the deficiencies determined by the Commissioner (R. 62-69) and the court below affirmed (R. 83-86).

ARGUMENT

1. Petitioner's principal reason for certiorari is an alleged conflict with *Lehigh Structural Steel Co. v. Commissioner*, 127 F. (2d) 67 (C. C. A. 3). But there is no more substantial basis for certiorari here than in *Warren Tel. Co. v. Commissioner*, 128 F. 2d 503 (C. C. A. 6), where a conflict with the *Lehigh* case was similarly alleged and where this Court, on January 11, 1943, denied certiorari, No. 550, present Term.

To be sure, the court in the *Lehigh* case held that provisions restricting the payment of dividends which appeared upon stock certificates could constitute a "contract" within the meaning of Section 26 (c) (1) of the 1936 Act, whereas the decisions here and in *Warren Tel. Co. v. Commissioner* indicate that such certificates are

not contracts within the meaning of Section 26 (c) (1). The significant consideration, however, is that regardless of whether such certificates are "contracts," the provisions in question are otherwise outside the scope of Section 26 (c) (1) both in this case and in the *Warren Tel. Co.* case for reasons which do not touch the *Lehigh* case.

The provisions of the stock certificates here involved simply forbid the distribution of dividends upon the common stock until dividends have been paid upon the preferred. But these provisions do not restrict the payment of either the delinquent or current dividends upon the preferred, which, as noted by the Board (R. 67-68), the taxpayer was financially able to pay; and upon payment of those dividends, the taxpayer would then be able to pay dividends upon its common. Thus, the provisions here involved merely established the order in which dividends may be paid to the two classes of stockholders. The purpose of the credit in Section 26 (c) (1) was to give relief to a corporation that could not pay dividends that would be taxable to the recipients. Here, however, the corporation could pay such dividends; it was merely required to pay them first to the holders of the preferred stock.

2. The second question upon which petitioner seeks review is whether its trust deed should be construed so as to prohibit payment of dividends

upon its common stock until all bond maturities and interest have been provided for out of earnings. The Board of Tax Appeals and the court below both held, correctly, we submit, that these obligations did not have to be met entirely out of earnings and it is undisputed that they were in fact paid from other sources as well (R. 27, 60-61, 65, 85; Pet. 16).

3. Moreover, even if the preferred stock and bond provisions were regarded as contracts restricting payment of dividends, nevertheless the taxpayer would not be entitled to the claimed credits. Section 26 (c) (1) allows a credit only for the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating such a contract. The taxpayer had enough *accumulated* earnings to have permitted it to meet the current bond retirement and interest and all preferred dividend obligations therefrom, thus enabling it to distribute its current earnings as dividends. See opinion of the Board of Tax Appeals (R. 68-69); *L. O. Koven & Brother, Inc. v. Commissioner*, 47 B. T. A. 467, 471, affirmed *per curiam* by the Circuit Court of Appeals for the Third Circuit on January 11, 1943 (1943 C. C. H., par. 9244); *Thew Shovel Co. v. Commissioner*, 45 B. T. A. 920, 927, affirmed on the opinion of the Board of Tax Appeals, February 11, 1943 (C. C. A. 6th). Both the

Board of Tax Appeals (R. 61, 68-69) and the court below (R. 84, 86) accepted as correct the figures shown on the taxpayer's books (R. 26, 54) with respect to its surplus. The calculations submitted by taxpayer purporting to show a deficit (Pet. 6-7) are based upon arbitrary deductions from the book figures. These calculations have no probative value and the record affords no basis for any contention that the taxpayer's books do not reflect its true surplus. Cf. *Doyle v. Mitchell Brothers Co.*, 247 U. S. 179, 187. The taxpayer has not shown itself entitled to any relief under Section 501 of the Revenue Act of 1942 (Appendix, *infra*), which amends the Revenue Act of 1936, and allows additional credits in the case of deficit corporations. The court below so concluded (R. 86) and the taxpayer has not raised any point as to this in the petition for certiorari.

CONCLUSION

The decision is correct and the petition should be denied.

Respectfully submitted.

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MARCH 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term “adjusted net income” means the net income minus the sum of—

(A) The normal tax imposed by section 13.

* * * * *

(2) The term “undistributed net income” means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

[Here follow graduated rates.]

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts restricting payment of dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of

the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

Revenue Act of 1942, Public Law 753, 77th Congress, 2d Session:

SEC. 501. ADDITIONAL CREDITS FOR UNDIS-
TRIBUTED PROFITS TAX.

(a) *Amendments to the Revenue Act of 1936.*—

(1) Section 14 (a) (2) of the Revenue Act of 1936 (relating to definition of undistributed net income) is amended to read as follows:

“(2) The term ‘undistributed net income’ means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g).”

(2) Section 26 (c) of the Revenue Act of 1936 (relating to credits of corporations) is amended by amending the heading to read as follows: “(c) *Restrictions on payment of dividends.*—”; and by amending paragraph (3) to read as follows:

“(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

“(4) *Double credit not allowed.*—If more than one of the credits provided in the foregoing paragraphs (1), (2) and (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the

credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

(3) Section 26 of the Revenue Act of 1936 (relating to credits of corporations) is amended by adding at the end thereof the following new subsections:

"(f) *Deficit credit*.—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103, or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax as computed under the amendments made by section 501 of the Revenue Act of 1942.

* * * * *

(b) *Effective date of amendments*.—The amendments made by subsection (a) shall be effective as of the date of the enactment of the Revenue Act of 1936.

(c) *Overpayments*.—If the refund or credit of any overpayment for any taxable year, to the extent resulting from the application of this section, is prevented on the date of the enactment of this Act or within one year from such date, then, notwithstanding any other provision of law or

rule of law (other than this subsection and other than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected under the Revenue Act of 1936, if claim therefor is filed within one year from the date of the enactment of this Act.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—

(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for

the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without

violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

* * * * *

